Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:HAR:TL-N-POSTF-127839-02
JFLong

date: May 31, 2002

to: Revenue Agent Joe D. Wyssmann, Financial Services, Team 1251, 6040 Earl Brown Dr. Brooklyn Center, MN 55430

from: Associate Area Counsel, LMSB, Area 1, Hartford, CT

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subject: [redacted] **Insurance Company. (Income taxes for [redacted] - [redacted])**

This memorandum responds to your request for assistance on May 3, 2002. This memorandum should not be cited as precedent.

ISSUE

Whether the mitigation provisions of I.R.C. §§ 1311-1314 allow [redacted] Insurance Company, a nonlife insurance company taxable under subchapter L, to avoid the statute of limitations for the [redacted] taxable year so that it can carryforward its ending unpaid loss reserve from [redacted] to its starting unpaid loss reserve for [redacted] in accordance with I.R.C. § 832(b)(5)? **UIL. Nos. 832.06-00 and 1312.05-00.**

CONCLUSIONS

1. It is our opinion that [redacted] Insurance Company is entitled to relief from the statute of limitations under the provisions of I.R.C. § 1312(4) so that it can calculate its unpaid losses in accordance with I.R.C. § 832(b)(5).

FACTS

A dispute arose during the examination of [redacted] Insurance Company's ([redacted]) income tax returns (Forms 1120PC) for [redacted], [redacted] and [redacted]. Since the dispute could not be settled the parties turned to the courts for resolution. The issue before the courts in [redacted], was whether [redacted] correctly reported its undiscounted unpaid losses, and related loss adjustment expense, for purposes of computing its deduction for losses incurred, as

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defined by I.R.C. § 832(b)(5). For each year in issue, [redacted] claimed deductions for increases in its discounted unpaid losses pursuant to I.R.C. § 832(b)(5) after discounting the amounts reported as undiscounted unpaid losses. The following chart summarizes the amounts claimed by [redacted] determined by the I.R.S., and ultimately allowed by the courts.

[redacted]

[redacted]'s [redacted] income tax return (Form 1120PC) was not examined by the IRS, and the taxpayer did not file a protective refund claim. The statute of limitations for filing refund claims for [redacted] has expired. [redacted]'s [redacted], [redacted] and [redacted] tax years are currently under examination. [redacted] wants to use the lower unpaid loss reserve amount determined by the court for [redacted], as its opening unpaid loss reserve for [redacted]. When the revenue agent explained that the statute of limitations for filing refund claims for [redacted] had expired [redacted] indicated an intent to argue the mitigation provisions solve its statute of limitations problem. To date, [redacted] has not provided any written submission explaining its position.

DISCUSSION

(a) Statute of Limitations for Claims for Refund:

The United States, as sovereign, is immune from suit unless it waives that immunity. Library of Congress v. Shaw, 478 U.S. 310, 315 (1986). A statute of limitations requiring that a suit against the government be brought within a specified time period constitutes a condition on the government's waiver of immunity, United States v. Mottaz, 476 U.S. 834, 841 (1986), and as such should be "construed strictly in favor of the sovereign,

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1/ [redacted] did not appeal the Tax Court's determination for the tax year [redacted]. The [redacted] Circuit affirmed the Tax Court's determinations for the years [redacted] and [redacted].

and not enlarge[d] . . . beyond what the [statutory] language requires." Ruckelshaus v. Sierra Club, 463 U.S. 680, 685 (1983).

With respect to suits against it for tax refunds, the United States has to some extent waived its sovereign immunity. Section 1346(a)(1) of Title 28 of the United States Code gives federal district courts jurisdiction over suits against the United States "for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected." However, the general jurisdictional grant in section 1346(a)(1) must be read to incorporate the requirements of I.R.C. §§ 7422(a) and 6511(a). United States v. Dalm, 494 U.S. 596, 610-12 (1990).

I.R.C. § 7422(a) provides that no suit for a tax refund may be maintained unless "a claim for refund or credit has been duly filed with the Secretary according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof." I.R.C. § 6511, in turn, constitutes one of these "provisions of law" governing refund claims.

As a general rule, I.R.C. § 6511[2] provides that a claim for refund must be filed within three years from the time the return is filed, or two years from the time the tax is paid. This same period was previously set forth in section 332(b) of the 1939 Code. See Jones v. Liberty Glass Co., 332 U.S. 524 (1947); Kearney v. A'Hearn, 210 F. Supp. 10, 18 (S.D. N.Y. 1961), aff'd, 309 F.2d 487 (2d Cir. 1962). The filing of a timely claim for refund is a prerequisite to instituting a suit for refund. I.R.C. § 7422(a); Hazzard v. Weinberger, 382 F. Supp. 225, 228 (S.D.N.Y. 1974); aff'd, 519 F.2d 1397 (2d Cir. 1975). Although section 7422 does not specifically refer to jurisdiction, it has been held that in the absence of a duly filed claim for refund neither the Court of Claims nor the federal district courts have jurisdiction to entertain a refund suit. Carson v. United States, 506 F.2d 745 (5th Cir. 1975); United States v. Freedman, 444 F.2d 1387 (9th Cir. 1971), cert. denied, 404 U.S. 992 (1971);

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[2] I.R.C. § 6511(a) provides in pertinent part:

> Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within three years from the time the return is filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid.

Mondshein v. United States, 338 F. Supp. 786, 788 (E.D.N.Y. 1971), aff'd, 469 F.2d 1394 (2d Cir. 1973). An untimely claim for refund is not duly filed. Crismon v. United States, 550 F.2d 1205, 1206 (9th Cir. 1977), cert. denied, 434 U.S. 807 (1977). The requirement that a claim for refund be filed prior to bringing a suit has withstood the taxpayer's challenge on the ground of denial of due process. Dodge v. Osborn, 240 U.S. 118, 122 (1916).

The period of limitations set forth in section 6511(a) requires that refund claims be filed within the later of three years of the time the tax return is filed, or two years of the time the tax is paid. [redacted]'s tax return (Form 1120PC) for [redacted] was filed on [redacted]. It is our understanding that no payments made after the filing of the tax return which would effect the statute of limitations for refund claims. Thus, the time for filing a timely claim for refund for [redacted] expired on [redacted].

(b) Taxation of insurance companies:

[redacted], as a nonlife insurance company, is required to compute its taxable income under I.R.C. § 832. (See I.R.C. § 831). Under this statutory provision, gross income includes amounts earned from investment and underwriting income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. I.R.C. § 832(b)(1)(A). Underwriting income is defined as the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. I.R.C. § 832(b)(3). Losses incurred generally means losses incurred during the taxable year on insurance contracts, and includes increases for the year in discounted unpaid losses (as defined in I.R.C. § 846). I.R.C. § 832(b)(5)(A). As defined in I.R.C. § 846(b)(1), unpaid losses generally means unpaid losses shown in the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer. Unpaid losses include any unpaid loss adjustment expenses. I.R.C. § 832(b)(6).

Losses incurred is defined in I.R.C. § 832(b)(5)(A) which provides in relevant part:

> In general. -- The term "losses incurred" means losses incurred during the taxable year on insurance contracts computed as follows:

(i) To losses paid during the taxable year, deduct salvage and reinsurance recovered during the taxable year.

(ii) To the result so obtained, add all unpaid losses on life insurance contracts plus all discounted unpaid losses (as defined in section 846) outstanding at the end of the taxable year and deduct all unpaid losses on life insurance contracts plus all discounted unpaid losses outstanding at the end of the preceding taxable year.

(iii) To the results so obtained, add estimated salvage and reinsurance recoverable as of the end of the preceding taxable year and deduct estimated salvage and reinsurance recoverable as of the end of the taxable year.

Taxable income equals gross income, as described above, less certain deductions allowed under to section 832(c). I.R.C. § 832(a). One of the deductions allowed is for "losses incurred" as defined in section 832(b)(5). I.R.C. § 832(c)(4). Such a deduction could potentially duplicate the losses incurred that are taken into account in determining the underwriting income component of gross income under I.R.C. § 832(b)(3), but I.R.C. § 832(d) cures this problem by specifically prohibiting the same item from being deducted twice.

In calculating gross income for a nonlife insurance company, unwriting income = premiums - (losses incurred and expenses incurred). Losses incurred = losses paid in the current tax year - (salvage and reinsurance recovered in the current tax year) + unpaid losses at the end of the current tax year - unpaid losses from the previous tax year + (estimated salvage and reinsurance from the previous tax year) - (estimated salvage and reinsurance from the current tax year). The bottom line effect on gross income for a nonlife insurance company is that gross income is reduced for the current tax year to the extent its estimate of unpaid losses for the current tax year exceed its estimate of unpaid losses for the proceeding tax year. Conversely, a nonlife insurance company's gross income increases for the current tax year to the extent that its estimate of unpaid losses for the current tax year is less than its estimate of unpaid losses for the proceeding tax year. Therefore, [redacted]'s taxable income is increased each year by the amount of any decrease in its unpaid losses. And [redacted]'s taxable income is decreased each year by the amount of any increase in its unpaid losses. The court decisions decreased the unpaid losses claimed by [redacted] on its tax returns (Forms 1120PC) for [redacted], [redacted] and [redacted] in the amounts of [redacted]

[redacted] and [redacted] respectively. The adjustment to unpaid losses for [redacted] flows through to [redacted] which likewise flows thorough to [redacted]. If [redacted] had filed a timely protective refund claim for [redacted], the changes to unpaid losses would flow thorough to [redacted].

(c) The Mitigation Provisions:

The mitigation provisions of I.R.C. §§ 1311 through 1314 set forth a highly complicated and integrated set of provisions authorizing the correction of errors which are otherwise prevented by operation of law such as the lifting the bar of the statute of limitations on assessing taxes or asserting a claim for refund. These sections were designed to prevent a windfall, in specified circumstances, either to the taxpayer or to the government arising out of the treatment of the same item in a manner inconsistent with its erroneous treatment in a closed year. Bolten v. Commissioner, 95 T.C. 397, 402 (1990). These provisions are written with great specificity and are not formulated to provide general equitable relief in every situation involving double tax benefit or detriment arising out of inconsistent tax treatment. B.C. Cook & Sons, Inc. v. Commissioner, 65 T.C. 422, 427-28 (1975), aff'd, 584 F.2d 53 (5th Cir. 1978). The statute does not purport to permit the correction of all errors and inequities. Evans Trust v. United States, 462 F.2d 521, 524 (Ct. Cl. 1972). The burden of proof is on the party seeking to utilize the mitigation provisions to prove they apply to its case. Yagoda v. Commissioner, 39 T.C. 170, 178 (1962), aff'd, 331 F. 2d 485 (2d Cir. 1964).

In order for the mitigation provisions to apply, four conditions must be met:

First, an error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law. See, I.R.C. § 1311(a).

Second, there must be a "determination" for an open tax year. As defined in I.R.C. § 1313(a), a "determination" is a final decision by a court, a closing agreement, a final disposition of a claim for refund, or an agreement under Treas. Reg. § 1.1313(a)-4.

Third, the determination must result in a circumstance under which an adjustment is authorized by I.R.C. § 1312. The seven circumstances under which an adjustment is authorized involve double inclusion of an item of gross income; double allowance of a deduction or credit; double exclusion of an item of gross income; double disallowance of a deduction or credit; correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs; correlative deductions and credits for certain related corporations; and, basis of property after erroneous treatment of a prior transaction.

Fourth, depending on which circumstance of adjustment applies, either an inconsistent position must be maintained by the party against whom mitigation will operate, or the correction of the error must not have been barred at the time the party for whom mitigation will operate first maintained its position. I.R.C. §§ 1311(b)(1) and (2).

Turning to the specific facts of this case it is our opinion that the first of the conditions required for mitigation has been met. [redacted] erroneously overstated its unpaid loss reserves for the ending of [redacted] and the beginning of [redacted]. The statute of limitations for refund claims for [redacted] has expired. Therefore, an error has occurred in a closed tax year that cannot otherwise be corrected by operation of law. I.R.C. § 1311(a).

The second condition required for mitigation has likewise been met because there has been a determination by the courts for the open year [redacted]. I.R.C. § 1313(a)(1).

The determination of whether the third condition required for mitigation has been met is something of a close call. The only circumstance under I.R.C. § 1312 that seems to fit the facts here is the double disallowance of a deduction. I.R.C. § 1312(4). The court's decision decreased the ending balance for the reserve for unpaid losses for the open year [redacted]. Absent statute of limitations problems, the court determined ending balance for the unpaid loss reserve for [redacted] would be the opening balance for the unpaid loss reserve for [redacted]. As previously discussed, unpaid losses are a component in the calculation of losses incurred. Losses incurred in turn can be used as a component in the calculation of gross income under I.R.C. § 832(b)(1),(3) and (5), or can be claimed as a deduction under I.R.C. § 832(c)(4), It is our understanding that [redacted] accounted for its unpaid losses as part of the calculation of gross income under I.R.C. § 832(b). Can this reduction to gross income as part of the calculation of taxable income be considered a deduction for purposes of the mitigation provisions?

In B.C. Cook & Sons v. Commissioner, 65 T.C. 422 (1975), aff'd, 584 F. 2d 53 (5th Cir. 1978), the company's bookkeeper embezzled money by writing fictitious checks. The checks were reflected in the company's books and records as part of cost of goods sold. When the embezzlement was discovered the company claimed a deduction for the theft loss. The IRS argued that the mitigation provisions should lift the statute of limitations to allow an assessment of tax for the prior years where the amounts now being deducted as a theft loss were claimed as part of cost of goods sold. The courts held against the IRS reasoning that a reduction in gross income is not a deduction for mitigation purposes. B.C. Cook & Sons v. Commissioner, supra, 428.

Based on the reasoning in B.C. Cook & Sons it could be argued that there has been no double denial of a deduction here because the court's decision for [redacted] merely made an adjustment to gross income and did not deny a deduction. The Service has, however, announced that it will not follow B.C. Cook & Sons. In A.O.D. 1977-77 (April 4, 1977), 1977-2 C.B. 2, the Service stated that the mitigation provisions should be interpreted to effect the Congressional purpose of preventing inequitable taxation or tax avoidance. The decision in B.C. Cook & Sons follows an overly literal interpretation of the word deduction for purposes of mitigation. Deduction should be interpreted to mean an item which reduces gross income whether included in calculation of cost of goods sold or deducted in the technical sense. This is especially true if the item can at the taxpayer's option be included in cost of goods sold or deducted. A taxpayer's wholly fortuitous choice of accounting practices should not effect the applicability of the mitigation provisions.

Applying the rational of A.O.D. 1977-77 (April 4, 1977), 1977-2 C.B. 2., to this case, it is our opinion that the courts decision to reduce unpaid losses claimed by [redacted] in [redacted] is the denial of a deduction for mitigation purposes whether [redacted] accounted for unpaid losses as part of the calculation of gross income under I.R.C. § 832(b) or as a deduction under I.R.C. § 832(c).

The next question is whether the court decision reducing the ending reserve for unpaid losses for [redacted], and the statute of limitations preventing the carryforward of the court determined year end unpaid loss reserve to the opening unpaid loss reserve for [redacted], is a permanent denial of a deduction, or merely a delay to a later year. Each year a nonlife insurance company deducts its paid losses, and sets up a reserve for, and deducts its estimate of unpaid losses. The reserve is rolled forward from year to year. In the end, when the policies are closed out, the total amount deducted should equal paid losses. If the unpaid losses denied by the court decision in [redacted] and by the statute of limitation in [redacted] are actually deducted in a later year, then mitigation would not apply since there would be no double denial of a deduction. It is our opinion, however, that the denial of the deduction for unpaid losses by the statute of limitations in [redacted] is a permanent denial of the deduction.

The following charts illustrate the effect of changes in the unpaid loss reserve on income and deductions.

Chart I: Unpaid loss reserves as reported on tax returns.[3]

[redacted]

Chart II: Unpaid loss reserves as redetermined by the court and carried forward from [redacted] to [redacted].

[redacted]

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[3] The numbers in the charts have been simplified for illustration purposes. I have assumed that the opening and closing balances for [redacted] are the same as the opening balance for [redacted], and that the opening balance for [redacted] is the same as the closing balance for [redacted], except where prohibited by the statute of limitations. I have likewise assumed that closing balance for [redacted] is the same as the opening and closing balances for [redacted].

Chart III: Unpaid loss reserves as redetermined by the court but prevented by the statute of limitations from being carried forward from [redacted] to [redacted].

[redacted]

As shown in chart III, if the court's determination of closing balance for unpaid losses for [redacted] is prevented from being carried forward and used as the opening balance for the unpaid loss reserve for [redacted], [redacted] will permanently lose a [redacted] dollar deduction. Based on the foregoing it is our opinion that the third condition for mitigation has been met. I.R.C. § 1312(4).

The fourth and final condition that must be met for the mitigation provisions to apply is set forth in I.R.C. § 1311(b). In general, I.R.C. § 1311(b)(1) requires that an inconsistent position must be maintained by the party against whom mitigation will operate. However, where relief is sought because of a double exclusion of income (I.R.C. § 1312(3)(B)), or a double disallowance of a deduction (I.R.C. § 1312(4)), the inconsistent position rule of I.R.C. § 1311(b)(1) does not apply. Instead, we must look to I.R.C. § 1311(b)(2) which requires that the correction of the error must not be barred at the time the party for whom mitigation will operate first maintains its position in writing. In this case, [redacted] is seeking relief because of the double disallowance of a deduction (I.R.C. § 1312(4)). It is our opinion that [redacted] has satisfied the requirements of I.R.C. § 1311(b)(2). At the time [redacted] filed its tax return for [redacted], the statute of limitations for claiming a refund or credit for [redacted] was still open. (See, Treas. Reg. § 1.1312-4).

Based upon the above discussion, we conclude that the mitigation provisions provide relief from the statute of limitations for [redacted]. Since there is no further action required by this office, we are closing our file in this matter. Please contact Joseph F. Long at 860-290-4090 should you have any questions.

[redacted]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

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